



# **CORRECTION METHODS FOR 401(k) FAILURES**

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**Employee Plans Voluntary Compliance**



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# OVERVIEW

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This outline illustrates Voluntary Correction Program (VCP) correction methods for 401(k) plan failures. These correction methods are consistent with the following core correction principles contained in Section 6 of Rev. Proc. 2008-50 (“2008-50”):

- Full correction includes all taxable years, whether or not the taxable year is closed.
- The correction method should restore the Plan and its participants to the position they would have been in had the failure not occurred.

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## OVERVIEW- Cont'd

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- **The correction should be reasonable and appropriate for the failure.**
  - The correction methods outlined in Appendices A and B of 2008-50 are deemed to be reasonable.
  - Other correction methods may be acceptable depending on the facts of the particular submission. In evaluating other correction methods VCP tries to achieve consistency with the IRC, provide benefits to NHCEs (particularly for nondiscrimination failures), and keep assets in the plan.
  - A 401(k) correction method shouldn't violate any other plan requirements set forth in Code Sec. 401(a).



# OVERVIEW- Cont'd

## Exceptions to Full Correction (section 6.02(5) of 2008-50)

- Reasonable estimates (can use these if it is not possible to obtain precise data, or if the probable difference between the use of precise data or estimated data is insignificant);
- Corrective distributions of \$75 or less (and admin costs of delivery are higher than distribution amount);
- Recovery of small overpayments of \$100 or less;
- Locating lost participants-Reasonable actions must be taken to find all current and former participants and beneficiaries to whom additional benefits are due, but who have not been located after a mailing to the last known address. **NOTE: EFFECTIVE AUGUST 31, 2012, THE IRS LETTER FORWARDING PROGRAM IS NO LONGER AVAILABLE.** For details please see recently issued Rev. Proc. 2012-35;
- Small excess amounts of \$100 or less; and
- Certain terminating orphan plans.



# EMPLOYER ELIGIBILITY FAILURE

- **Failure:** A 401(k) plan is adopted by an ineligible employer. An ineligible employer is one that is not authorized to establish and maintain a 401(k) plan, such as a 501(c)(3) non-profit corporation establishing a 401(k) plan prior to 1996 or the adoption of a 401(k) plan by a governmental entity.
- **Correction:** Stop all contributions to the plan not later than the VCP submission date. This includes both salary deferrals and after tax contributions. Keep existing assets in the plan until a distributable event (e.g. death, disability, termination of employment). Appendix F, Schedule 6 may be able to be used to correct this failure. In accordance with Section 6.03(2) of 2008-50 cessation of contributions is *not* required if continuing such contributions would not cause an Employer Eligibility Failure.



# EXAMPLE

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Do Good Inc., a non-profit 501(c)(3) exempt organization, adopted a 401(k) plan in 1994. At the time the plan was established, Do Good was ineligible to sponsor a 401(k) plan. In 2011 Do Good realizes the error and files a VCP submission. Because Do Good is now eligible to sponsor a 401(k) plan it would not be required to cease further contributions to the plan as part of the correction for the Employer Eligibility Failure.



# EXCLUSION OF ELIGIBLE EMPLOYEES - *NON-SAFE HARBOR PLAN*

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- **Failure:** Improperly excluded employees weren't provided with the opportunity to make an election to defer income to the 401(k) plan. This failure may also include the failure to receive an allocation of employer matching contributions.
- **Correction:** In accordance with section .05(2) of Appendix A and section 2.02(1)(a)(ii)(B) of Appendix B, the employer must make a qualified non-elective contribution (QNEC) to the plan equal to the "missed deferral opportunity." This amount is 50% of the employee's "missed deferral," which is the actual deferral percentage (ADP) for the employee's group (NHCE or HCE) multiplied by the employee's compensation for the year. The QNEC must be adjusted for earnings. Note, however, that the missed deferral cannot exceed the 402(g) or other plan limits. Pursuant to section 2.02(1)(a)(ii)(A) of Appendix B, if the exclusion only occurred during part of the year, the missed deferral is computed using the plan compensation only during the portion of the year the employee was excluded.





# EXCLUSION OF ELIGIBLE EMPLOYEES - *NON-SAFE HARBOR PLAN- CONT'D*

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- A corrective contribution will also be required if the plan provides for matching contributions and, as a result of being improperly excluded, the participant did not receive an allocation of matching contributions. The corrective contribution is equal to whatever the match would have been had the employee deferred an amount equal to the missed deferral, adjusted for earnings. In general, the match can be contributed as a QNEC or as a match that is subject to the plan's vesting schedule.
- If the employee should have been eligible to make after-tax employee contributions (this does NOT include designated Roth contributions) a QNEC will be based on a special "missed opportunity for making after-tax employee contributions" which is equal to 40% of the employee's "missed after tax contributions." This equals the actual contribution percentage (ACP) attributable to employee after-tax contributions for the employee's group (NHCE or HCE) multiplied by the employee's compensation. This amount is adjusted for earnings and is subject to applicable Plan limits. The Plan Sponsor must also make the applicable matching contribution QNEC on such amount.



# EXCLUSION OF ELIGIBLE EMPLOYEES - *NON-SAFE HARBOR PLAN- CONT'D*

- **Note:** Pursuant to section 2.02(1)(a)(ii)(F) of Appendix B, a QNEC is not required if the employee was excluded for a brief enough period of time during the year such that the employee has an the opportunity to make up the missed elective deferrals over a period of at least 9 months in that plan year. This exception is limited to brief periods of exclusion. Exclusion for a brief period late in the year, or exclusion of a small portion of compensation from deferral, would not fall within this limited exception.
- **Note:** Even though a QNEC is not required for the missed deferral when the employee has been provided the opportunity to make deferrals for a period of at least 9 months, in accordance with section 2.02(1)(a)(ii)(F) of Appendix B a corrective contribution *is* required with respect to any matching contributions attributable to the period when the employee was excluded. The matching contribution is calculated by first multiplying the ADP of the employee's group (NHCE or HCE) by the plan compensation for the brief period of exclusion, and calculating the match based on such deemed deferred amount. The total of the deemed deferred amount and the actual deferred amount for the at-least 9 month period when the participant was actually able to make deferrals cannot exceed the Code Sec. 402(g) limit on deferrals, The matching contribution is computed on such deemed deferred amount in accordance with, and subject to the limitations provided by, the plan provisions for matching contributions.



# EXAMPLE

Genco, Inc. sponsors a 401(k) plan with 80 participants. The plan uses the calendar year as its plan year. The plan has a one year of service eligibility requirement and provides for January 1 and July 1 entry dates. The plan provides a 5% matching contribution on deferrals. Marlina, a Genco employee who should have been provided the opportunity to make elective deferrals on January 1, 2010, was not provided the opportunity until January 1, 2011. Marlina was an NHCE with 2010 plan year compensation of \$80,000. The ADP for HCEs for 2010 was 10%. The ADP for NHCEs for 2010 was 8%. Genco discovers this mistake during a review of the plan in 2011 and submits a VCP application.

Genco must make a corrective contribution for the 2010 missed deferral opportunity. Marlina's missed deferral is equal to the 8% ADP for NHCEs multiplied by her \$80,000 compensation earned for the portion of the year in which Genco erroneously excluded Marlina (January 1 through December 31, 2010). The missed deferral amount, based on this calculation, is \$6,400 ( $\$80,000 \times 8\%$ ). The missed deferral opportunity is \$3,200 (50% multiplied by the missed deferral of \$6,400). Accordingly, Genco is required to make a corrective contribution of \$3,200 for Marlina. Genco must adjust this corrective contribution of \$3,200 for earnings through the date of correction. Genco must also make a corrective matching contribution based on the missed deferral. In this case that would be  $5\% \times \$6,400$ , or \$320, adjusted for earnings.



# EXAMPLE

On January 1, 2010 Rachel, an NHCE, became eligible to participate in the Exco 401(k) plan, which uses a calendar year as its plan year. However, she was not given the opportunity to make elective deferrals until April 1, 2010. Rachel's 2010 plan compensation was \$80,000. The plan's 2010 ADP for NHCEs was 5%. The plan provides a 6% match on deferrals up to a maximum of \$2,000. Rachel was permitted to defer up to \$16,500 (the 2010 402(g) limit) during the period April 1-December 31, 2010. She elected to defer 5% of her compensation received during that period.

Because Rachel had an opportunity to make deferrals for 9 months during the plan year, Exco is entitled to rely on the special rule for brief exclusions. Exco is not required to make a QNEC for the missed deferral opportunity attributable to the 3 month period of exclusion, but is required to make a corrective matching contribution for this period. The matching contribution is calculated based on the amount Rachel is deemed to have deferred during the 3 month period using the ADP for her NHCE group. Thus, Rachel is deemed to have deferred  $5\% \times \$20,000$  (the portion of plan compensation received during the 3 month period), or \$1,000. The 6% match calculated on such deemed deferred amount is \$60. Exco makes a corrective matching contribution of this amount, together with earnings.



# EXAMPLE

On January 1, 2010 Jane, an NHCE became eligible to participate in the Vinco 401(k) Plan, a calendar year plan. However, Jane was not given the opportunity to make elective deferrals until April 1, 2010. Jane elected to defer 25% of her \$80,000 2010 plan compensation. In 2010 the ADP for the NHCE group was 8%. Vinco made a 10% matching contribution on deferrals up to a maximum of \$1,600.

During the period from April 1, 2010 through December 31, 2010 Jane deferred 25% x 60,000, or \$15,000. Her deemed deferral for the 3 month period of exclusion, on which the corrective matching contribution is calculated, is  $8\% \times \$20,000$  or \$1,600. However, the 402(g) limit for 2010 is \$16,500. Thus, only \$1,500 of the deemed deferred amount for the brief period of exclusion is used to compute the corrective matching contribution.

The 10% match for the portion of the year when Jane was allowed to make elective deferrals (April 1-December 31) totaled \$1,500. The 10% match on the \$1,500 deemed deferral (taking into account the 402(g) limits) for the period of exclusion is \$150. However, the plan provides a \$1,600 cap on matching contributions. Thus, Vinco is only required to make a \$100 corrective matching contribution, together with earnings.



# EXCLUSION OF ELIGIBLE EMPLOYEES - *SAFE HARBOR PLAN*

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- **Failure:** Improperly excluded employees weren't provided the opportunity to make an election to defer income to a safe-harbor 401(k) plan. Because this failure involves a safe harbor 401(k) plan, rather than looking to the ADP to compute the missed deferral, a special safe harbor missed deferral is computed, as explained below.
- **Correction:** In accordance with section .05(2) of Appendix A and section 2.02(1)(a)(ii)(B) of Appendix B, the employer must make a QNEC to the plan equal to the "missed deferral opportunity" plus the matching contribution that would apply based on the "missed deferral". The "missed deferral opportunity" is 50% of the employee's "missed deferral." In a safe harbor plan with a safe harbor match the "missed deferral" is deemed to be equal to the **greater** of: 1) 3% of compensation; or 2) the maximum deferral percentage for which the employer provides a matching contribution rate that is at least as favorable as 100% of the elective deferral made by the employee.



# EXCLUSION OF ELIGIBLE EMPLOYEES - *SAFE HARBOR PLAN- cont'd*

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- In a safe harbor plan with non-elective contributions instead of a safe harbor match, the missed deferral is 3% of compensation. In addition the employer must contribute the required matching contribution based on the missed deferral. The corrective contribution is adjusted for earnings. The missed deferral cannot exceed the 402(g) or other plan limits. Pursuant to section 2.02(1)(a)(ii) of Appendix B, if the exclusion only occurred during part of the year, the missed deferral is computed using the plan compensation only during the portion of the year the employee was excluded.
- **Note:** Pursuant to section 2.02(1)(a)(ii)(F) of Appendix B, a QNEC is not required if the employee was excluded for a brief enough period of time during the year such that the employee has an the opportunity to make up the missed elective deferrals over a period of at least 9 months in that plan year. However, a corrective contribution for the missed matching contribution attributable to the brief period of exclusion is required and is determined in accordance with section 2.02(1)(a)(ii)(F) of Appendix B.



# EXAMPLE

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Bunco, Inc. sponsors a safe harbor 401(k) plan which requires matching contributions equal to 100% of elective deferrals that do not exceed 3% of compensation and 50% of elective deferrals that exceed 3% of compensation but do not exceed 5% of compensation. In 2010 Alfredo was improperly prevented from participating in the plan and making an election to defer compensation. Alfredo's 2010 plan compensation was \$60,000. The missed deferral for Alfredo is the greater of: 1) 3% of compensation (\$1,800) or; 2) the maximum deferral percentage for which the employer provides a matching contribution rate that is at least as favorable as 100% of the elective deferral made by the employee (in this case also 3% of compensation). The missed deferral opportunity is 50% of this or \$900. The required matching contribution based on such missed deferral is \$1,800. Thus, Bunco must make a corrective contribution for Alfredo equal to \$2,700 (\$900 for the missed deferral opportunity plus \$1,800 for the missed matching contribution), adjusted for earnings.





# FAILURE TO PROVIDE SAFE HARBOR NOTICE

- **Failure:** The Plan Sponsor fails to provide the safe-harbor notice required by Code Sec. 401(k)(12). This notice includes details about whether the employer will make matching or non-elective contributions, other contributions under the terms of the Plan, the Plan to which the safe harbor contributions are made if the employer sponsors more than one Plan, the type and amount of compensation that may be deferred under the Plan, the method for making cash or deferred elections, the specific time periods available to make such elections, withdrawal and vesting provisions for Plan contributions, and how to obtain additional information about the plan (including a copy of the Summary Plan Description). The failure to provide the notice violates the Plan's safe harbor provisions, and causes the Plan to fail to operate in accordance with the terms of the Plan document.
- **Correction:** If the failure results in an employee not being able to make elective deferrals (either because such employee wasn't informed about the Plan, or informed about how to make deferrals to the Plan), then correction would require that the employer make a QNEC equal to 50% of such employee's missed deferral. Because this is a safe-harbor Plan, the missed deferral is deemed to be equal to the greater of: 1) 3% of compensation; or 2) the maximum deferral percentage for which the employer provides a matching contribution rate that is at least as favorable as 100% of the elective deferral made by the employee. Such contribution must be adjusted for earnings. In addition, the employer must contribute the required matching contribution based on the missed deferral. See "EXCLUSION OF ELIGIBLE EMPLOYEES - SAFE HARBOR PLAN" for an example of how this is calculated.

If the failure to provide the safe harbor notice did not prevent the employee from being able to make an informed, timely deferral election, and all required matching and non-elective contributions were made based on such deferrals, then in an appropriate case the Plan Sponsor may not be required to make a corrective contribution for such failure. Instead, it would be required to amend its administrative procedures going forward to ensure that the proper safe harbor notice is provided to all participants.



# PREMATURE INCLUSION OF EMPLOYEES

- **Failure:** Employer allows employees who have not satisfied the conditions for becoming participants in the plan to make elective deferrals and/or receive matching contributions.
- **Correction:** If the prematurely included employees are primarily NHCEs then, depending on the facts in a particular VCP submission, the employer may be able to retroactively amend the plan to allow such employees to become participants retroactive to when they began making elective deferrals. Such amendment must be evaluated for discriminatory impact under Code Sec. 401(a)(4) and cutback potential under Code Sec. 411(d)(6).
- Alternately, the Plan Sponsor may distribute the amount of improper elective deferrals to the employees, providing written notification to the employees indicating that the distribution they received is taxable, not subject to favorable tax treatment, and cannot be rolled over to an IRA or other qualified retirement plan. The employees must forfeit any matching contribution. If the amount in the employees' 401(k) account is less than the amount contributed for the year of the failure, the employer will need to make a corrective contribution.



# EXAMPLE

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MoCo adopted a 401(k) plan in 2005. The plan document provides that employees become eligible to participate in the plan after completing one year of service. Hector was allowed to participate in the plan in 2010 without satisfying the one year of service requirement. He deferred \$5,000 into the plan in 2010. He received a matching contribution of \$500 on such amount. Hector did not defer any amount in 2011. On January 1, 2012 MoCo files a VCP submission for the failure and elects not to amend the plan to permit Hector to not have to satisfy the one year of service requirement. At the time of the correction the amount of Hector's \$5,000 deferral is worth only \$4,200. The matching contribution is worth \$400.

MoCo must make a corrective contribution of \$800 so that Hector's deferral amount is restored to \$5,000. This amount is distributed to Hector with proper written notification. Hector forfeits the \$400 matching amount, which will be placed in the plan's forfeiture account to be applied or allocated in accordance with the terms of the plan.



# FAILURE TO IMPLEMENT DEFERRAL ELECTIONS

- **Failure:** An employer fails to implement an employee's filed deferral elections- this may occur with respect to pre-tax deferrals and/or post-tax deferrals. In the case of pre-tax deferrals, the failure causes the employee to receive taxable compensation (instead of being able to defer) for the elected amount. By not being deposited into the employee's 401(k) account, the employee is also prevented from accumulating tax-free earnings on the deferred amounts. If the employee would have been entitled to receive matching contributions on the intended deferral, this additional failure must also be addressed.
- **Correction:** The Plan Sponsor must make a 50% corrective contribution for the missed deferral opportunity attributable to pre-tax deferrals (50% of employee's elected deferral percentage x employee's plan compensation), adjusted for earnings. Note: Unlike an employee excluded from the plan whose deferral election isn't known, here the employee has indicated his/her deferral percentage. Thus, the corrective contribution is based on the participant's actual election instead of the ADP. There is a 40% QNEC for after-tax deferrals (40% of employee's elected after-tax contribution percentage x employee compensation).



# FAILURE TO IMPLEMENT DEFERRAL ELECTIONS- CONT'D

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- For failure to make matching contributions on the missed deferral, the employer must make a matching contribution QNEC based on actual deferral or after-tax contribution percentage (don't apply 50% and 60% reductions). All QNECS must be adjusted for earnings. Because this is a QNEC the employee is fully vested in the contributions, but is subject to the same withdrawal restrictions that apply to elective deferrals.
- **Note:** A Plan Sponsor cannot avoid liability to make corrective contributions for the missed deferral opportunity by making its employees responsible for checking pay records to ensure deferral election has been implemented. The employee's elective deferrals (the sum of deferrals actually made and the missed deferrals, for which a corrective contribution is required) cannot exceed the 402(g) limits and must comply with all other applicable plan limits/requirements.



# EXAMPLE

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- Nadia is employed by Missco, which sponsors a 401(k) plan that does not include a matching contribution. Nadia is eligible to participate in the plan, and in 2010 completes an election deferral form indicating that she wants 5% of her compensation to be deferred as a pre-tax contribution. Nadia's 2010 plan compensation is \$60,000. Missco never implements Nadia's election in 2010. The amount of \$3,000 of Nadia's 2010 compensation should have been deferred. Missco must make a QNEC equal to \$1,500 plus earnings



# AUTOMATIC ENROLLMENT FAILURES- *FAILURE TO IMPLEMENT THE AUTOMATIC ENROLLMENT PERCENTAGE*

- **Failure:** The Plan Sponsor fails to implement the Plan's automatic enrollment provisions. A participant who is provided with the enrollment materials for a plan having an automatic enrollment feature is treated as having elected to make a contribution equal to the plan's automatic enrollment deferral percentage unless he/she make an affirmative alternate election to increase or decrease such percentage. The enrollment materials generally include a plan description and the procedures for making an election to contribute an amount (including a zero amount) other than the automatic enrollment deferral percentage.
- **Correction:** By failing to implement the Plan's automatic enrollment provisions for an employee who did not make an alternate election, the Plan has failed to implement the participant's deemed deferral election. The missed deferral is the plan's automatic enrollment deferral percentage multiplied by the participant's compensation. The required corrective contribution is 50% of such missed deferral.



# EXAMPLE

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Tipco, Inc. sponsors a 401(k) plan that has an automatic enrollment feature with a 3% automatic enrollment deferral percentage. Barry became eligible to participate in the 401(k) plan on January 1, 2011; his plan compensation in 2011 is \$50,000. In November of 2010, Tipco provided Barry with the the Plan's enrollment materials but Barry never made any specific election. By not making an alternate election Barry is considered to have elected the plan's automatic enrollment deferral percentage. However, Tipco Plan fails to implement such automatic enrollment provision for Barry in 2011. The missed deferral for Barry is computed as the Plan's automatic deferral percentage (3%) multiplied by Barry's 2011 plan compensation (\$50,000), or \$1,500. The corrective contribution required for Barry is 50% of the missed deferral amount, or \$750, plus earnings computed on such amount.





# AUTOMATIC ENROLLMENT FAILURES- *EMPLOYEE TREATED AS AN EXCLUDED PARTICIPANT*

- **Failure:** An employee never receives the enrollment materials for a plan providing an automatic enrollment feature and is thereby prevented from making any kind of election (either a default election by doing nothing, or an affirmative alternate election).
- **Correction:** The employee is treated as an excluded participant rather than as a participant whose election has not been implemented. The correction for an excluded employee is for the Plan Sponsor to make a corrective contribution equal to the missed deferral opportunity. This amount is 50% of the employee's missed deferral, which is the actual deferral percentage (ADP) for the employee's group (NHCE or HCE) multiplied by the employee's compensation for the year.



# EXAMPLE

Sara became eligible to participate in the Arpo, Inc. 401(k) plan on January 1, 2011. The Arpo Plan has an automatic enrollment feature. Due to an oversight, Arpo failed to provide Sara with the plan's enrollment materials which included the procedures for electing to contribute an amount other than the automatic enrollment deferral percentage. Sara didn't make any specific election and the Plan didn't implement the automatic enrollment provision for Sara. The ADP for NHCEs in 2011 is 5%. Sara, who is an NHCE, earned \$50,000 in Plan compensation in 2011. Sara's missed deferral is determined using the applicable ADP for 2011. Sarah's missed deferral amount is computed by multiplying the ADP for her NHCE group (5%) by her 2011 Plan compensation (\$50,000), or \$2,500. The missed deferral opportunity is 50% of this amount, or \$1,250. Arpo makes a corrective contribution in this amount for Sara, together with earnings.



# EXCLUSION OF ELIGIBLE EMPLOYEES- *CATCH-UP CONTRIBUTIONS ONLY*

- **Failure:** Eligible employees weren't provided with the opportunity to make catch-up contributions as permitted under the plan. An employer is not required to provide for catch-up contributions in any of its plans. However, if a plan allows catch-up contributions, it must allow **all** eligible participants to make the same election with respect to catch-up contributions. A participant can make annual catch-up contributions up to the **lesser** of the following amounts: 1) the annual catch-up contribution dollar limit; or 2) the excess of the participant's compensation over the elective deferral contributions that are not catch-up contributions. **Note:** Elective deferrals are not treated as catch-up contributions until they exceed the deferral limit under Code Sec. 402(g) (\$17,000 for 2012), the ADP test limit of section 401(k)(3) or any plan limit on deferrals.
- **Correction:** The employer must make a QNEC to the plan equal to the "missed deferral opportunity" attributable to catch-up contributions. The missed deferral for catch up contributions is one-half of the yearly catch up contribution limit. The missed deferral opportunity is equal to 50% of the employee's missed deferral (50% x one-half of the yearly catch up limit). If the plan provides for matching contributions the employer must make a QNEC based on what the match would have been on the missed deferral amount.



## EXCLUSION OF ELIGIBLE EMPLOYEES- *CATCH-UP CONTRIBUTIONS ONLY- CONT'D*

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- If an employee has been excluded from making *any* deferrals then ordinarily no additional correction with respect to catch-up contributions is required because the deemed elective deferral is below the threshold for being eligible to make a catch-up contribution.



# EXAMPLE

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Zinco, Inc. sponsors a 401(k) plan that provides for catch-up contributions, has no limits on deferrals other than the 402(g) limit, and satisfies all ADP testing without regard to any catch-up contributions. The plan provides for a 10% matching contribution on elective deferrals. Tammy, age 55 and an NHCE, elected to defer 20% of her plan compensation in 2011. Her 2011 plan compensation was \$82,500. Thus, Tammy made elective contributions of \$16,500, which was the 2011 Code Sec. 402(g) limit. Tammy was not, however, provided with the opportunity to make a catch up contribution election. The catch-up contribution limit for 2011 was \$5,500. The missed deferral is  $50\% \times \$5,500$  or \$2,750. The QNEC for such missed deferral is 50% of the missed deferral or \$1,375. Tammy is also entitled to a matching contribution on the missed deferral ( $10\% \times \$2,750$ , or \$275). Thus Zinco must make a QNEC for Tammy of \$1,650 (\$1,375 + \$275).



# EXAMPLE

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Roco, Inc. sponsors a 401(k) plan that provides for catch-up contributions and no matching contributions. The plan uses the calendar year as its plan year. The 2011 ADP for NHCES is 5%. Luke, a 53 year old NHCE with \$60,000 plan compensation in 2011, became eligible to participate in the Roco plan on January 1, 2011. However, Luke was never provided the opportunity to participate in the plan in 2011.

Because Luke was an excluded employee for 2011, Roco will need to make a QNEC based on Luke's missed deferral opportunity. The missed deferral is the 5% ADP x Luke's \$60,000 compensation, or \$3,000. The missed deferral opportunity is 50% of this amount, or \$1,500. Although Luke was unable to make a catch up contribution in 2011, his deemed elective deferral (\$3,000) is below the \$16,500 2011 elective deferral threshold for being eligible to make a catch-up contribution.



# ROTH FAILURES- *BACKGROUND*

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It's important to distinguish Roth contributions from after-tax employee contributions:

- As of January 1, 2006 Plan Sponsors are permitted amend their 401(k) plan document to allow employees to elect to make their contributions to a designated Roth account. Roth contributions are after-tax contributions that will not be taxed on later distribution in accordance with the special rules governing Roth distributions. A participant's combined elective deferrals-- whether to a traditional 401(k), a Roth 401(k), or to both-- cannot exceed the 402(g) limit (taking into account any permitted catch-up contributions). Thus, every dollar contributed to a Roth 401(k) account counts against the employee's 402(g) limit on contributions. If a plan permits designated Roth contributions, it must also offer pre-tax elective deferral contributions.
- A withdrawal of contributions and earnings from a Roth 401(k) is not taxed if it is a qualified distribution. This requires that the account be held for at least 5 years and that the distribution be made because of disability, after death, or after attainment of age 59½.



## ROTH FAILURES- *BACKGROUND- cont'd*

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- The Plan Sponsor can make matching contributions on designated Roth contributions but these contributions do not receive the favorable “tax free on distribution” Roth tax treatment. The matching contributions made on account of designated Roth contributions must be allocated to a pre-tax account, just as matching contributions are on traditional, pre-tax elective contributions.
- By contrast, after-tax employee contributions are contributions from compensation (other than Roth contributions) that an employee must include in income on his or her current tax return. At the time of distribution, the employee pays no tax on the portion of the distribution attributed to the after-tax contributions he or she made but, unlike in a Roth account, does have to pay tax on any gains.





# ROTH FAILURES- *EXCLUSION OF AN ELIGIBLE EMPLOYEE*

- **Failure:** A 401(k) Plan permits designated Roth deferrals but an eligible employee has been excluded from the Plan and therefore was denied the opportunity to make Roth deferrals.
- **Correction:** In accordance with section .05(3) of Appendix A, the corrective contribution for a missed deferral opportunity arising from the improper exclusion of an eligible employee isn't impacted by whether the plan permits an employee to designate all or a portion of elective deferrals as Roth contributions. The corrective employer contribution is still 50% of the missed deferral opportunity. The missed deferral is computed by multiplying the ADP for the employee's category (NHCE or HCE) by the employee's compensation during the period of exclusion.

The corrective contribution may not be treated as designated Roth contribution (and may not be included in an employee's gross income) and thus may not be contributed or allocated to a designated Roth account. The corrective contribution must be allocated to an account established for receiving a QNEC or any other employer contribution in which the employee is fully vested and that is subject to the withdrawal restrictions that apply to elective deferrals.



# EXAMPLE

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Malik became eligible to participate in the Lago, Inc. 401(k) plan on January 1, 2011. The Lago Plan permits designation of all or a portion of deferrals as Roth 401(k) contributions. Throughout 2011 Malik was never provided with the opportunity to make deferrals or participate in the plan. Malik is an NHCE and his 2011 plan compensation was \$70,000. The ADP for NHCEs in the Lago Plan in 2011 was 6%. As an improperly excluded employee, Malik is entitled to have Lago make a QNEC to the plan equal to his “missed deferral opportunity.” This amount is 50% of Malik’s “missed deferral,” which is the 6% ADP for the NHCE group multiplied by his 2011 \$70,000 plan compensation. The missed deferral opportunity contribution Lago must make is, therefore,  $\frac{1}{2} \times \$4,200$  or \$2,100. Such QNEC must be adjusted for earnings. None of this corrective contribution may be treated as a designated Roth contribution (and will not be included in Malik’s gross income) and thus may not be contributed or allocated to a designated Roth account.



# FAILURE TO HONOR ROTH ELECTIONS- *EMPLOYER WITHHOLDS AND DEPOSITS PRE-TAX DEFERRALS FOR A PARTICIPANT WHO ELECTED AFTER-TAX ROTH DEFERRALS*

- **Failure:** A plan allows employees to designate their deferrals as Roth deferrals, an employee elects to have after-tax Roth deferrals made, but the deferrals made for the employee are withheld and deposited as pre-tax deferrals.
- **Correction:** There is no “standard” correction for this failure. In Section 2.02(3) of 2008-50 comments were requested about possible correction methods. Until such comments are considered, and correction methods are identified, one of the following ***might*** (depending on the facts) be an acceptable method to address this failure:
  - Transfer the erroneous deposited deferrals from the pre tax account to the Roth account. The employer would issue a corrected W 2 for the year of the failure. The participant would be required to file an amended Form 1040 return for the year of the failure; ***or***
  - Transfer the contribution deposited to the pre-tax account (together with earnings) to the Roth account and include the amount so transferred in the participant’s compensation in the year of the transfer; ***or***
  - Transfer the contribution deposited to the pre-tax account (with earnings) to the Roth account and have the participant include the amount so transferred in the participant’s compensation in the year of the transfer. In addition, the employer might be required to make a “gross up” payment to the participant to make the participant whole for the resulting income tax.



## FAILURE TO HONOR PARTICIPANT PRE-TAX ELECTION- PLAN WITHHOLDS AND DEPOSITS ROTH DEFERRALS FOR A PARTICIPANT WHO ELECTED PRE-TAX DEFERRALS

- **Failure:** A plan allows employees to designate their deferrals as Roth deferrals, an employee elects to have only pre-tax deferrals made, but the deferrals made for the employee are withheld and deposited as Roth deferrals.
- **Correction:** There is no “standard” correction for this failure. In Section 2.02(3) of 2008-50 comments were requested about possible correction methods. Until such comments are considered, and correction methods are identified, the following ***might*** (depending on the facts) be an acceptable method to address this failure:
  - Transfer the erroneously deposited deferrals from the Roth account to the pre-tax account. The employer files a corrected W-2 for the year of the failure and the employee files an amended Form 1040 for the year of the failure. This essentially places the employee in the same position as if the failure hadn’t occurred. However, such correction will not be available if the time period for filing a refund claim has expired.



## DEFERRALS BASED ON IMPROPER COMPENSATION - *EMPLOYER DOESN'T APPLY DEFERRAL ELECTION TO CERTAIN ELEMENTS OF COMPENSATION*

- **Failure:** An employer improperly excludes bonuses, overtime, commissions or another element of compensation from the compensation base on which employees may make elective deferrals.
- **Note:** An employer may allow employees to designate a separate election for elements of compensation such as bonuses. However, in the absence of such separate election, an employer cannot simply treat the employee as having made either a zero or reduced election for such items; the employee's usual deferral percentage must be applied to these items.
- **Note:** Deferrals should also be made on post-severance compensation (payments made within 2½ months after severance from employment, and that would have been paid to the employee for either 1) services or as overtime or shift differential, or as commissions, bonuses, or other similar compensation; or 2) accrued bona fide sick, vacation, or other leave if the employee would have been able to use the leave if employment had continued) but not on severance pay.



## DEFERRALS BASED ON IMPROPER COMPENSATION - *EMPLOYER DOESN'T APPLY DEFERRAL ELECTION TO CERTAIN ELEMENTS OF COMPENSATION- CONT'D*

- **Correction:** Missed deferrals attributable to excluded elements of compensation need to be determined. Generally, the employee's elected percentage of compensation would be used to determine the amount the employee would have deferred from the excluded elements. The corrective contribution for the missed deferral opportunity would be 50% of the missed deferral (adjusted for earnings). If the plan calls for matching contributions, a corrective contribution must be made equal to the full matching contribution that the employee would have received (adjusted for earnings) had the missed deferral (attributable to the excluded element(s) of compensation) been made to the plan. Do not apply the 50% missed deferral opportunity rate. Any missed discretionary contributions on the omitted compensation (plus earnings) must also be contributed.



# EXAMPLE

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Ginco, Inc. had 4 employees in 2010. The plan document for the Ginco 401(k) plan provides that bonuses are included in the definition of compensation. Alan and Lourdes were the only employees receiving bonuses in 2010, and each received a \$20,000 bonus. They each also elected to defer 5% of compensation. In 2010 Ginco decided to make a discretionary profit sharing contribution equal to 6% of compensation on behalf of each employee. In operation, the contribution was calculated without regard to Alan and Lourdes' bonuses. The total compensation for all 4 employees excluding bonuses was \$200,000, with each employee earning \$50,000. Thus, each employee received a \$3,000 profit sharing contribution. The missed deferral for Alan and Lourdes is \$1,000 each ( $5\% \times \$20,000$ ). Ginco must contribute 50% of this amount (\$500) plus earnings each to Alan and Lourdes' account. Alan and Lourdes should also each receive a \$1,200 ( $6\% \times 20,000$ ) contribution for the discretionary profit sharing contribution.



# EXAMPLE

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Bonco, Inc. sponsors a 401(k) plan that has 40 participants. In November 2009 the plan's definition of compensation for deferrals is amended effective for the 2010 plan year to exclude bonuses. In operation, however, Bonco failed to exclude bonuses from 2010 compensation before determining deferrals. Three HCEs properly deferred 6% of their \$120,000 base compensation (\$7,200 each), but improperly deferred 6% of their \$30,000 bonuses (\$1,800 each). Bonco must distribute the improperly allocated elective deferrals of \$1,800 plus earnings to each of the three HCEs.





## DEFERRALS BASED ON IMPROPER COMPENSATION - *EMPLOYER APPLIES DEFERRAL ELECTION TO ITEMS THAT AREN'T COMPENSATION*

- **Failure:** An employer improperly permits deferrals on items that are not included in the plan's definition of compensation for deferral purposes. For example, if the plan definition of compensation *excludes* bonuses, and an employee elects to defer 5% of compensation, a failure would arise if the employer applied that same 5% deferral to bonus payments made to the employee.
- **Correction:** The employer makes a distribution of the excess elective deferrals plus earnings to the participant. Any discretionary profit sharing contribution or matching contribution made with respect to such excess will be forfeited and either reallocated to other participants or used to offset future employer contributions, depending on the terms of the plan. As an alternative to such correction method, the employer may be able to adopt a retroactive amendment to include the items of compensation on which deferrals have been made in operation. However, such amendment would need to be analyzed for discriminatory impact under Code Sec. 401(a)(4) and cutback potential under Code Sec. 411(d)(6).



# A WORD ABOUT EARNINGS

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- In general, earnings on any required corrective contributions must be computed using the actual plan earnings based on the employee's investment choices for the period of the failure. A negative adjustment for losses can be made but is not mandatory.
- If using the employee's investment choices isn't practical (records may not be available or such earnings may be difficult/impossible to compute) or the employee was an excluded employee who didn't make investment choices, and the employee (or most of the employees if correction is for more than one employee) for whom a corrective contribution is being made is an NHCE then the Plan Sponsor may use the rate of return of the fund with the highest earnings rate under the Plan.
- If computations of actual earnings would result in significant administrative cost and the probable difference between precise computations and an approximation of such amounts is insignificant, then a reasonable estimate may be used or, if not feasible to estimate, a reasonable interest rate may be used, such as the interest rate used by the DOL VFCP Online Calculator.



# ADP/ACP TESTING FAILURES

- **Failure:** The plan fails ADP/ACP testing. This testing is designed to ensure that the amount of contributions made by and for rank-and-file employees, (nonhighly compensated employees (NHCEs)), are proportional to contributions made for owners and managers. The **ADP** test is met if the ADP for the eligible HCEs does not exceed the greater of: • 125% of the ADP for the group of NHCEs, or • the lesser of: 200% of the ADP for the group of NHCEs, or the ADP for the group of NHCEs plus 2%. The **ACP** test is met if the ACP for the eligible HCEs does not exceed the greater of: • 125% of the ACP for the group of NHCEs, or • the lesser of: 200% of the ACP for the group of NHCEs, or the ACP for the group of NHCEs plus 2%. Every 401(k) plan other than safe harbor and certain automatic enrollment plans must satisfy yearly ADP/ACP testing.
- **Correction:** Pursuant to section .03 of Appendix A, the correction method is to determine the amount necessary to raise the ADP or ACP of the NHCEs to the percentage needed to pass the tests. The Plan Sponsor must make a QNEC for the NHCEs to the extent necessary to pass the tests. The QNEC must be made for all eligible NHCEs (as long as the contribution does not cause the Code Sec. 415 limit to be exceeded). The contributions must be the same percentage for each participant. Note: Reg. §1.401(k)-2(a)(6)(iv) provides guidance concerning non-uniform contributions.



# ALTERNATIVE CORRECTION

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Alternately, under section 2.01(1)(b) of Appendix B, the employer can use the one-to-one correction method. Excess contribution amounts (adjusted for earnings) are assigned and distributed to the HCEs. Any forfeited amounts due to matching contributions must be used in accordance with the plan document provisions relating to forfeitures. That same dollar amount (the excess contribution amount, adjusted for earnings) must be contributed (in the form of a QNEC) to the plan and allocated pro rata, based on compensation, to all eligible NHCEs. A plan sponsor whose plan fails ADP testing may NOT just retroactively amend the plan to make it a 401(k) safe harbor plan providing for a 3% safe harbor nonelective contribution on behalf of NHCEs.



# QNEC SOURCE

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- Because a QNEC must be a contribution that is fully vested at all times, forfeitures cannot be used to fund QNECs used to correct failed ADP/ACP tests (forfeitures typically represented the non-vested portion of terminated participants' accounts).



# ADP/ACP TESTING FAILURES - *EXAMPLES*

- **Example 1:** Acme, Inc. maintains a profit-sharing plan with a 401(k) feature for its employees. During 2012, Acme performed a review of the plan's operations for the 2010 plan year, which revealed that one participant identified as an NHCE was the child of a 5% owner. When Acme re-ran the ADP test with the corrected classification, HCEs had an ADP of 7% and NHCEs had an ADP of 4%. Pursuant to Code Sec. 401(k)(3), the maximum passing ADP for the HCE group is 6%; therefore, the plan failed the ADP test. There were no matching or other employee contributions for the 2010 plan year. The plan has 21 participants. Acme files a VCP submission for the failure. Acme can make a QNEC on behalf of the NHCEs in the amount necessary to raise the ADP to a percentage that would enable the plan to pass the test. In this example, each NHCE would receive a QNEC equal to 1% of the employee's compensation. Alternately, Acme can use the one-to-one correction method illustrated in Example 2 below.



# ADP/ACP TESTING FAILURES - *EXAMPLES*

- **Example 2:** Nuco, Inc. maintains a 401(k) plan which does not provide for matching contributions or after tax employee contributions. It uses the current year testing method. Due to computational errors, in 2011 Nuco discovers that it failed the ADP test in 2009. Using correct computations, NUCO determines that the ADP for HCEs in 2009 was 8% and the ADP for NHCEs was 4%. Because the ADP for HCEs exceeded the ADP for NHCEs by more than two percentage points the plan violated 401(k)(3). There were only 2 HCEs in the plan, Ali and Binh. Ali had 2010 plan compensation of \$200,000 and deferred 8% (\$16,000). Binh also had 2010 plan compensation of \$200,000 and deferred 8% (\$16,000). Nuco elects to use the one-to-one correction method. Under this method Nuco must determine the excess contribution amounts which would be assigned to HCEs adjusted for earnings. It must then apportion the amount of the excess contributions among the HCEs. It must also calculate income allocable to such excess contributions. The apportioned excess contributions, adjusted for earnings, is distributed to the HCEs. An amount equal to the distributed amount is then contributed to the plan and allocated pro-rata, based on compensation, among the eligible NHCEs. In this example \$8,000 in excess contributions plus income thereon will be distributed- \$4,000 (plus earnings) to Ali and \$4,000 (plus earnings) to Binh, reducing the ADP for HCEs to 6%. In addition, the employer will contribute \$8,000 adjusted for earnings (i.e. amount distributed to the HCEs) to the plan. The contribution is allocated to NHCEs pro-rata based on compensation.



# ADP TESTING METHOD FAILURES- *USING THE WRONG YEAR*

- **Failure:** An employer who previously elected to use the current year testing method in running the ADP test uses prior year testing in operation or, conversely, an employer who elected prior year testing uses current year testing in operation.
- Under Code Sec. 401(k)(3)(A) and companion regulations (§1.401(k)-2(c)(1)) a change from current year testing to prior year testing is generally only permitted in limited circumstances. A change from prior year testing to current year testing is generally permitted at any time.
- **Correction:** If an employer elected prior year testing but in operation used current year testing to run its ADP test VCP may be able to permit a retroactive amendment reflecting such practice if the Plan Sponsor provides sufficient evidence of employer intent and employee expectation. If the employer elected current year testing but in operation used prior year testing, then in addition to such analysis the employer must demonstrate that it falls within one of the following situations described in §1.401(k)-2(c)(1)(ii):
  1. The plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan);

( cont'd on next page)





# ADP TESTING METHOD FAILURES- *USING THE WRONG YEAR- cont'd*

2. The plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan); or
3. A transaction occurs that is described in Code Sec. 410(b)(6)(C)(i) and Treas. Reg. §1.410(b)-2(f); as a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and the change from the current year testing method to the prior year testing year method occurs within the transition period described in § 410(b)(6)(C)(ii).



# IRC 402(G) LIMIT VIOLATIONS

- **Failure:** The aggregate amount of elective deferrals made by a participant to one or more plans of a single employer exceeds the Code Sec. 402(g) annual limit. The employer failed to distribute such excess by the tax filing deadline for the year of the excess deferral. The limits on elective deferrals under §402(g) are: 2005 - \$14,000; 2006 - \$15,000; 2007 - \$15,500; 2008 - \$15,500; 2009 - \$16,500; 2010 - \$16,500; 2011 - \$16,500; and 2012 - \$17,000.
- **Correction:** Under section .04 of Appendix A, the appropriate correction is to distribute the excess deferral to the employee and report the amount as taxable income in the year of deferral and in the year distributed. Thus, the employee is subject to double taxation on the excess deferral. This cannot be avoided if the correction is made after the tax-filing deadline for the year in which the excess deferrals were made. The distributions are subject to the 10% additional tax on early distributions, 20% withholding and spousal consent requirements.
- Note that the failure addressed here only arises if the 402(g) limit is exceeded due to deferrals made to one or more plans of a single employer. If an employee works for two or more employers and makes deferrals to 2 or more unrelated plans-- none of which individually exceed the 402(g) limit but which do so in the aggregate-- then VCP cannot address the problem. The employee must report the excess deferral as income for the year in which the excess deferral occurred. The employee does not have basis in the excess deferrals previously reported as income when distributions are made from the plan. Thus, the same excess deferrals are includible as income a second time when these amounts are distributed. The amount distributed to HCEs but not NHCEs is included in the ADP test.



# EXAMPLE

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Arpco, Inc. maintains a §401(k) plan with 230 participants. For calendar year 2010, Arpco permits 30 of the plan's participants each to defer \$18,000 to the plan. All of these participants are under age 50 and therefore none are eligible to make catch-up contributions. Each of these 30 employees has excess deferrals of \$1,500 because \$16,500 is the §402(g) maximum amount permitted for 2010 ( $\$18,000 - \$16,500 = \$1,500$ ). Arpco does not discover this mistake until May 2011, at which time Arpco files a VCP submission. Arpco must distribute the excess deferral (plus applicable earnings) to each employee who was permitted to make deferrals in excess of the Code Sec. 402(g) limit. For 2010 (year of deferral), each affected employee must include \$1,500 in gross income. For 2011 (year of distribution), each affected employee must include \$1,500 plus earnings in gross income. This amount would be shown on Form 1099-R and the affected employees must also pay the §72(t) additional tax.



# ELECTIVE DEFERRALS NOT SUSPENDED FOLLOWING FINANCIAL HARDSHIP WITHDRAWALS

- **Failure:** Elective deferrals weren't suspended following financial hardship withdrawals as required by the plan terms. Pursuant to Treas. Reg. §1.401(k)-1(d)(3)(iv)(E)(2) a plan (or other legally enforceable agreement) must prohibit an employee from deferring or making employee contributions for at least 6 months after receipt of a hardship distribution.
- **Correction:** Current taxable distribution of the 6 months' worth of "improper" deferrals, adjusted for earnings. Where appropriate, the employee must also forfeit any matching contributions associated with such deferrals.
- **Example:** Misaki is a participant in the Carco, Inc. 401(k) plan. In 2010 Misaki elected to defer 5% of her compensation. Her 2010 plan compensation was \$50,000, paid in equal bi-weekly installments. On June 15, 2010 Misaki took a hardship distribution from the plan. Carco failed to suspend Misaki's elective deferrals for a six month period following such hardship withdrawal. Such suspension should have occurred during the six month period between July 1, 2010 and December 31, 2010. Instead, Misaki was permitted to defer \$1,250 during this period. Carco files a VCP application in 2012 for its failure to have suspended deferrals. Carco must distribute \$1,250 plus earnings to Misaki to correct the failure.



# HARDSHIP DISTRIBUTIONS AND PLAN LOAN FAILURES - *NO PLAN PROVISION*

- **Failure:** An employer permits participants in its 401(k) plan to take plan loans and/or hardship distributions. The plan document does not contain provisions allowing plan loans and/or hardship distributions.
- **Correction:** The plan may be amended retroactively to permit these. The amendment would generally be effective on the first date of the plan year in which a plan loan and/or hardship distribution (as applicable) was made. The amendment must satisfy the qualification requirements of Code Sec. 401(a) as of the effective date of the amendment.
- **Example:** In 2008 Bilco, Inc. adopted a 401(k) plan which contains no provisions concerning plan loans. During 2010 Bilco permitted two NHCE participants, Magali and Lian, to take plan loans. The loans are scheduled to be repaid in equal monthly installments within five years of when the loans were incurred. Neither of the loans is in default. In 2012 Bilco submits a VCP application seeking to correct the failure. An acceptable correction might be to allow Bilco to retroactively amend the plan as of January 1, 2010 to permit all employees to take plan loans.



# GENERAL CORRECTION PRINCIPLES FOR PLAN LOANS

- In order for a plan loan to not be considered a taxable distribution to the participant pursuant to Code Sec. 72(p)(1), it must satisfy the requirements of Code Sec. 72(p)(2)(A) (relating to the maximum amount of the loan), Code Sec. 72(p)(2)(B) (generally requiring that the loan be repayable within five years, with an exception for certain home loans), and Code Sec. 72(p)(2)(C) (requiring level amortization and not less than quarterly payments of the loan). These requirements are discussed in greater detail on subsequent slides.
- If a plan loan fails to satisfy the requirements of Code Sec. 72(p)(2)(A), (B) or (C), but is properly corrected within the maximum repayment period for repayment under Code Sec. 72(p)(2)(B) (generally five years), then the employer is able to request relief from reporting such loan as a deemed distribution.
- If correction cannot be completed before the expiration of the maximum repayment period for repayment under Code Sec. 72(p)(2)(B), then the only relief available through VCP is the ability to report the loan as a deemed distribution in the year of correction rather than the year of the failure.
- In appropriate cases Appendix F, Schedule 5 may be used to report the failure and request relief as described above. However, if the affected participant is either a key employee (as defined in Code Sec. 416(i)(1)), or an owner-employee (as defined in Code Sec. 401(c)(3)), then Appendix F, Schedule 5 can only be used to request reporting the loan as a deemed distribution in the year of correction instead of the year of the failure. A request for relief from reporting a loan to such individuals as a deemed distribution in both the year of the failure and the year of correction, even if the failure is corrected within the maximum repayment period for repayment under Code Sec. 72(p)(2)(B), must be presented on Appendix D.



## PLAN LOAN FAILURES - *LOAN AMOUNT IN EXCESS OF CODE SEC. 72(P)(2)(A) LIMIT*

- **Failure:** A plan sponsor permits a participant to take one or more plan loans exceeding the Code Sec. 72(p)(2) limit. In general, the amount of a loan cannot exceed the **lesser** of : a) 50% of the participant's vested account balance (but not less than \$10,000); or b) \$50,000 reduced by the highest amount owed on other loans taken by the participant during the prior one year period.
- **Correction:** If the original term of the loan does not exceed 5 years and such period has not expired, then the participant repays the excess amount to the plan. The remaining principal balance of the loan may then be reamortized over the remaining period of the original loan. In this case the plan sponsor is able to request relief from reporting the loan as a deemed distribution under Code Sec. 72(p)(1). The period for repayment cannot extend beyond five years from the date of the original loan, determined without regard to any cure period provided by the terms of the loan.
- **Example:** Sapna took a plan loan of \$55,000 from her account in the Menco, Inc. 401(k) plan in June 2006. The maximum permitted plan loan she could have taken that year is \$50,000. Menco files a VCP application in August 2007 for the failure. The application states that Sapna repaid the \$5,000 excess amount to the plan on July 1, 2007. The portion of any loan repayments Sapna made during the year of the failure which are attributable to the \$5,000 excess may be applied in one of several possible ways. Here, the repayments were applied first to interest on the excess loan amount and the remainder applied to the maximum permitted principal amount. The remaining loan balance after the \$5,000 repayment may be reamortized over the remaining outstanding term of the loan.



## PLAN LOAN FAILURES - *LOAN TERM IN EXCESS OF CODE SEC. 72(P)(2)(B)*

- **Failure:** A plan sponsor permits a participant to take a plan loan that by its terms provides a period of repayment that is more than five years, contrary to Code Sec. 72(p)(2)(B) (there is an exception to the maximum five year term for certain principal residence loans).
- **Correction:** A loan that provides a repayment period longer than five year doesn't satisfy the Code Sec. 72(p)(2) exception and, therefore, is considered a plan distribution in the year the loan is made. However, if the loan has been outstanding no more than five years then the remaining principal balance of the loan may be reamortized over the remaining portion of the maximum five year repayment period. The plan sponsor is then able to request relief from reporting the loan as a deemed distribution under Code Sec. 72(p)(1). The period for repayment cannot extend beyond five years from the date of the original loan, determined without regard to any cure period provided by the terms of the loan.
- **Example:** Kerry took a plan loan of \$25,000 from his account in the Semco, Inc. 401(k) plan on June 1, 2009. The loan provided a six year term. In 2011 Semco files a VCP application for the failure. At the time of the submission the outstanding principal balance on the loan is \$16,000. Correction would involve re-amortizing such \$16,000 outstanding balance over a period ending not later than May 31, 2014, reflecting the maximum five year repayment period.





# PLAN LOAN FAILURES - *DEFAULT*

- **Failure:** An employee fails to make loan repayments in accordance with the schedule for repayments, and such failure extends beyond any cure period. This includes a situation where an employer makes a permitted plan loan to an employee which is to be repaid through paycheck reductions, but fails to make the reductions and the failure is discovered after any applicable cure period.
- **Correction:** Either the participant may repay the missed payments plus accrued interest in lump sum, repaying the balance over the remaining term, or the loan balance may be reamortized over the remaining term (it's possible that some combination of both might be acceptable). The period for repayment cannot extend beyond five years from the date of the original loan, determined without regard to any cure period provided by the terms of the loan. If the default is due to employer error the employer may offer (or be required) to repay the interest on the unpaid amount.
- **Note:** If correction cannot be completed before the expiration of the maximum period for repayment of the loan under Code Sec. 72(p)(2)(B) (generally five years), then the only relief available through VCP is the ability to report the loan as a deemed distribution for the year of the correction instead of the year of the failure. Such distribution is reported on Form 1099-R. Generally the Plan Sponsor will be required to pay income tax withholding on the amount that was required to be paid with respect to such deemed distribution.



# EXAMPLE

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Pinco maintains a 401(k) plan that permits plan loans. Kwan, a participant in the Pinco plan, borrowed \$8,000 from his 401(k) account in 2009. Kwan starts to make the required loan repayments but in 2010 misses three payments on the loan. The error is discovered after any applicable cure period. Pinco submits a VCP application in 2011. The failure may be corrected either by Kwan making a lump sum payment to the plan equal to the missed payments, with accrued interest, or Pinco reamortizing the outstanding balance of the loan within the five year period from the date of the loan (determined without regard to any cure period provided by the terms of the loan), resulting in higher future payments for Kwan, or some combination of the above.



# LATE REMITTANCE OF DEFERRALS

- **Failure:** An employer fails to remit participants' elective deferrals by the earliest date the employer can reasonably segregate the deferral deposits from general assets. It is important to note that this may NOT be a failure for VCP purposes (but will be a prohibited transaction for DOL purposes) if the plan does not have language relating to the timing of the contributions being deposited. If the plan does include such language then there may be a qualification failure for failing to follow the terms of the plan.
- **Correction:** The correction is for the employer to make the contributions with earnings up to the date of correction. Earnings should be based on the actual earnings of the participant's account. The change in procedures as described in the submission should include new safeguards to ensure that the deposit is made by the earliest date the employer can reasonably segregate the deferral deposits from general assets.
- **Example:** Emco, Inc. sponsors a 401(k) plan for its employees, all of whom are participants in the plan. Emco pays its employees on the 15<sup>th</sup> and 30<sup>th</sup> day of the month. The Emco plan expressly provides that Emco must deposit deferrals within five days after each payday. Emco conducts a yearly compliance audit of its plan. During this review, it discovered it deposited elective deferrals 30 days after each payday for the 2010 plan year. Because Emco failed to make the deposits within the time required by the plan document, this is an operational failure correctible under VCP. Emco must deposit any missed elective deferrals into the trust, along with lost earnings.